In The

Supreme Court of the United States

October Term 1977

No. 77-904

DANIEL L. SHULL,

Petitioner,

vs.

DAIN, KALMAN AND QUAIL, INC., AND HARRY WARE,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Petitioner is the plaintiff below who sought to determine liability, if any, on the part of the defendants, and each of them, for alleged violation of, among other things, the Securities Act of 1933 and the Securities Exchange Act of 1934, in connection with the purchase and sale of Securities. He prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in this proceeding on August 26, 1977; and the denial of the hearing by said court on September 26, 1977.

OPINIONS BELOW

The September 30, 1976 opinion of the United States District Court for the District of Nebraska remains unreported at this time, and is reproduced in the Appendix at pages 1-15. The August 26, 1977 opinion of the United States Court of Appeals for the Eighth Circuit is reported at 561 F. 2d 152 and is reproduced in the Appendix at pages 15-34. The order denying Petition for Rehearing was entered on September 26, 1977 without opinion, and is reproduced in the Appendix at page 35.

JURISDICTION

The judgment of the Court of Appeals for the Eighth Circuit was entered on August 26, 1977. A timely petition for rehearing was filed and considered by the Court; said petition was denied on September 26, 1977, and the Petition for Certiorari will be filed within 90 days of the date of denial. This Court's jurisdiction is invoked pursuant to the provisions of 28 U. S. C. § 1254 (1) and Rule 22 (3) of the Supreme Court Rules.

QUESTION PRESENTED

Whether under *Ernst & Ernst v. Hochfelder,* the scienter requirement necessary for recovery under § 10(b) of the Securities Exchange Act of 1934, can be established by showing reckless misstatements of material facts, or statements made with reckless disregard for the truth.

STATUTES AND REGULATIONS INVOLVED

Pursuant to § 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. § 78j(b)), the Securities and Exchange Commission promulgated Rule 10b-5 (17 C. F. R. § 240.10 (b) (5)).

15 U. S. C. § 78j(b) provides in relevant part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, . . .
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10(b)5 of the Securities and Exchange Commission states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

This petition presents for decision a significant issue in the area of federal securities fraud. The Courts below decided an important question of federal law which has not been decided by this Court, and which should be decided by this Court to promote uniformity of decisions among the several Circuits.

The petitioner, Daniel L. Shull, plaintiff-appellant below (hereinafter Shull), petitioned the Federal District Court for the District of Nebraska to determine liability on the part of Dain, Kalman & Quail and Harry Ware (defendants-appellees below, hereinafter Ware whether one or both), for alleged violations of, among other things, the Securities Act of 1933 and the Securities Exchange Act of 1934. Jurisdiction of the Court was invoked pursuant to 15 U. S. C. § 77b (a), as amended, and 15 U. S. C. § 78 (aa), as amended.

Shull forwarded ten theories of liability; the central theory of recovery being whether Ware made misrepresentations of material facts, or failed to disclose other material facts, to the plaintiff, in connection with the purchase and sale of securities. Shull contended centrally that Ware violated § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. To support this theory, Shull offered evidence as to the conduct of Ware, and further offered to prove that Ware violated other provisions of the Securities laws, rules and regulations, in operating a course of business which operated as a fraud upon the plaintiff.

At the close of plaintiff's evidence, Ware moved to dismiss the complaint. The District Court, under the provisions of Rule 41(b), Federal Rules of Civil Procedure, held that upon weighing the evidence, Shull had failed to establish his causes of action against Ware by a preponderance of the evidence.

With respect to the alleged violations of § 10(b) and Rule 10b-5, the Court found that although Ware made misstatements of material facts, plaintiff failed to demonstrate that said misstatements were made with "intent to defraud" as required by this Court's mandate in the case of *Ernst & Ernst v. Hochfelder,* 425 U. S. 185 (1976).

On appeal, the Court of Appeals held that the District Court properly weighed the evidence before ruling on the motion to dismiss. The Circuit Court intimated that plaintiff's evidence on the fraud issue was convincing, but held that the District Court's finding of "no fraudulent intent" was not clearly erroneous, and refused to reverse.

Both Courts below discussed the underlying facts with regard to the conduct of the defendant alleged to be fraudulent. A further discussion of the facts at this point is unnecessary and reference is made to the opinions reproduced in the Appendix; specifically pages 1-6 of the District Court opinion (App. pp. 1-12) and pages 13-14 of the Circuit Court opinion (App. pp. 27-29). The more important facts will be discussed herein in connection with the reasons for granting the writ.

REASONS FOR GRANTING THE WRIT

I. The Circuit Court has decided an important question of federal law and intensified a conflict among the circuits on the issue of whether the scienter element of a § 10(b) violation, encompasses a reckless standard.

A. The decision of this Court in Ernst & Ernst v. Hochfelder, supra, established that some element of scienter was necessary to recover under § 10(b) of the Securities Exchange Act of 1934.

The issue presented by this Petition evolves directly from the substantive change in the area of federal securities fraud occasioned by this Court's holding in *Ernst & Ernst v. Hochfelder, supra.* Hochfelder added "some element of scienter" as a prerequisite to recovery under § 10(b) of the Securities Exchange Act of 1934; liability could no longer be imposed for mere negligent conduct. In footnote 12 of the *Hochfelder* opinion the Court stated "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question, whether in some circumstances, reckless behavior is sufficient for civil liability under Section 10b and Rule 10b-5." 425 U. S. at 193-94 n. 12.

This petition now asks the Court to address that issue, examine the holdings of the Courts below, as well as the holdings of the other Circuits, and define and clarify the "element of scienter" envisioned as necessary for recovery under Section 10(b); and further to resolve any developing disparity between the Circuits on that issue.

The principal contention of the petitioner Shull is that both the District Court and the Circuit Court ignored the possibility that the scienter element mandated by *Hochfelder* could be established by showing certain reckless conduct, or misstatements of material fact that were made with reckless disregard for the truth. In each case, the lower Courts were satisfied to dismiss plaintiff's fraud claim for want of proof sufficient to establish that the defendant Ware had acted with "intent to deceive, manipulate or defraud." Both Courts held Shull to an onerous burden of proof not mandated by *Hochfelder,* and inconsistent with the burden of proof established by other Circuit Courts.

B. The Courts below established a proposition of law with regard to scienter that did not include a recklessness standard, and totally ignored any discussion of the issue.

The record below was replete with incidents of questionable conduct on the part of Ware. The District Court found several material misrepresentations or omissions by Ware. Plaintiff's proof on the issue of misstatements was limited exclusively to matters of knowledge peculiar to Ware himself, and did not include misstatements which were matters of opinion or conjecture. For example, Ware had shown a persistent pattern of representing to his customers, including Shull, that he was personally familiar with the operation of the company whose stock he was recommending for investment, and that he was personally acquainted with the company's officers. That fact was clearly demonstrated to be untrue (App. pp. 8-9). The Circuit Court added, "There is no doubt that during

1972 Ware was pushing the stock in question and was making certain representations about his knowledge of the affairs of the issuing company which were not altogether true. For example, he stated that he was personally acquainted with some of the officers of the company which was not the case." (App. p. 26).

It was strongly urged below that this was the type of direct evidence of intent to defraud that this Court envisioned when it established the scienter requirement in *Hochfelder.* The District Court was apparently not convinced and while the Circuit Court was sympathetic, it could not reverse under the clearly erroneous standard. In fact, the Circuit Court stated, "the decision might well have gone the other way" on the fraud issue (App. p. 29).

Shull argued below that if this wasn't clearly intent to defraud, then it certainly represented culpably reckless conduct which the post *Hochfelder* Courts were accepting as an alternative to intentional deception. It was urged that since nobody knew, better than Ware, whether he knew the officers, Ware's misstatement of that fact was clearly reckless. However, the District Court failed to analyze the evidence in terms of a recklessness standard and the Circuit Court totally ignored the issue on appeal.

The error of law below which is the substance of this petition, can be gleaned from simply reading the opinions filed below. Both opinions avoid any discussion whatsoever on whether *Hochfelder* permits a "recklessness" standard as an alternative to an "actual intent to defraud" standard.

The District Court stated:

> In order for the plaintiff to recover upon the basis of untrue statements or omissions of the material facts under this rule, it is necessary that the plaintiff prove, among other things, that the untrue statement or omission was made with an intent to deceive, manipulate, or defraud. *Ernest & Ernest v. Hochfelder,* — U. S. —, 47 L. Ed. 2d 688 (1976). As earlier found, the plaintiff has not established by a preponderance of the evidence now before the court that any misstatement of fact or failure to state a fact was made with intent to deceive, manipulate, or defraud. (App. p. 13).

There was no further discussion by the District Court whatsoever on the issue of whether recklessness was a sufficient substitute for intent to deceive, manipulate, or defraud.

Similarly, the Circuit Court stated:

> In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), the Supreme Court held that a suit based on § 10 (b) and Rule 10 (b) (5) cannot be successfully maintained on the basis of negligence alone, and that in order to prevail a plaintiff must show scienter, that is to say a fraudulent, deceptive or manipulative intent. (App. p. 21).

Similarly, the Circuit Court made no mention of the issue of whether the recklessness would suffice. In fact, the Petition for Rehearing was directed at the Court's lack of discussion of the recklessness standard. However, the petition for rehearing was nonetheless denied.

The Courts below have taken the position that *Hochfelder* required evidence of—for want of a better term—a "smoking pistol". Their position is wholly inconsistent

with the developing law in the several Circuits on this issue, and ignores important aspects of securities fraud left open by the *Hochfelder* Court.

C. The Circuit Courts, analyzing Hochfelder, have concluded that where actual intent to defraud is not demonstrated, recovery under § 10(b) can be based upon a recklessness standard.

The misstatement of the law by the Courts below, and how it fosters disparity among the Circuits, becomes clear upon examining similar decisions, on similar issues, by other Circuit Courts. The Second Circuit, both pre and post *Hochfelder,* held that culpable conduct under Rule 10b-5 could be shown by:

> "facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud . . . [A] Plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had actual knowledge of any misrepresentations and omissions must establish, in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to willful, deliberate, or reckless disregard for the truth that is the equivalent to knowledge."

Lanza v. Drexel & Co., 479 F. 2d 1277, 1304-5 (2d Cir. en banc 1973); see, *SEC v. Universal Industries, Corp.,* CCH Fed. Sec. L. Rep. ¶ 95,804 (2d Cir. 1976).

The Second Circuit remains unchanged in its position with regard to recklessness. It continues to discuss the proposition of law regarding scienter, as encompassing the concept of recklessness, and remains apparently unaffected by the *Hochfelder* mandate. Even those Circuits

who were affected by *Hochfelder,* now phrase their scienter proposition of law in terms of recklessness.

In point is the case of *Sanders v. John Nuveen & Company, Inc.,* 545 F. 2d 790 (7th Cir. 1977). In *Sanders,* the Seventh Circuit, suffering the effects of the reversal in *Hochfelder,* stated that *Hochfelder* notwithstanding, "we believe contrary to Nuveen's urging, that 'reckless behavior' can be sufficient to constitute scienter." *Id.* 792. Again, it is noted that the opinion distinctly labels recklessness as "the lesser form of intent" which is still more culpable than mere "negligence", and less culpable than actual intent to defraud, yet sufficiently culpable to rise to the *Hochfelder* standard. In other words, the 7th Circuit has taken the position that where there is no "smoking pistol", the smoke, *or* the pistol, may suffice.

Similarly, in *First Virginia Bank Shares v. Benson,* 559 F. 2d 1307 (5th Cir. 1977) the Court, citing *Hochfelder,* stated:

> "Rule 10b-5 incorporates the scienter requirement; the defendant must know of the falsity of the information, *or* must act in *reckless* disregard of its falsity, *or* must intend to deceive." *Id.* 1314. (Emphasis supplied.)

Again, the Court's discussion includes a proposition of law which specifically examines the lesser element of "recklessness" as an alternative where the plaintiff is unable to meet the onerous burden of showing actual intent to defraud. Additionally, two recent District Court decisions have also stated the proposition of law with regard to scienter as encompassing the concept of recklessness. *See, SEC v. Cenco,* 436 F. Supp. 193 (D. C. Ill. 1977) and *Beecher v. Able,* 435 F. Supp. 397 (D. C. N. Y. 1977).

The Eighth Circuit had its "flexible duty" standard (*Myzel v. Fields*, 386 F. 2d 718 (8th Cir. 1967)) rejected by *Hochfelder*. The replacement offered by the Eighth Circuit in this case, now attempts to establish a proposition of law for fraud that exists nowhere in the law. Even the *Hochfelder* Court recognized the recklessness issue, although deciding not to rule on it.

Shull's fraud claim was dismissed because the District Court was not convinced that Ware's misstatement of material facts were made with intent to defraud, nor did his misstatements evidence an intent to defraud. Had Shull brought his action in the Seventh Circuit, he would have fared much better. In *Bailey v. Miester Brau, Inc.*, 535 F. 2d 982 (7th Cir. 1976), the plaintiff recovered under § 10 (b) where no actual intent to deceive was demonstrated. Liability was predicated upon the recklessness standard. The same result was reached in *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

Again, the error below is painfully obvious. A simple examination of the propositions of law cited above indicates that the standard for recovery established by the Courts below is inconsistent with the other circuits. It is incomprehensible that the Courts below could read the proper result on the issue of "scienter" when the evidence was examined under an improper proposition of law; one that ignored the alternative recklessness standard. The failure of the Courts below to even address the recklessness issue indicates one of two things: either the Circuit Court totally misconstrued the *Hochfelder* mandate, or decided to close the door in the Eighth Circuit on the recklessness issue, and adopt a fraud standard even higher in degree than contemplated by *Hochfelder*. In either event, the decision below should not be permitted to stand unreviewed. This Court should grant the Writ to be certain that the Courts below framed the scienter propositions of law correctly, and further to keep the Circuits from diversifying on the issue of "recklessness" the same way they split earlier on the requirement of scienter.

II. Failure to grant the writ will fuel the fires of future disagreement among the Circuits and negate the relative calm and unity occasioned by Hochfelder.

Ernst & Ernst v. Hochfelder, supra, is the singlemost important development in the area of securities fraud since this Court first recognized a private right of action under § 10 (b) in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S. 6 (1971). *Hochfelder* rightfully recognized the several Circuits were permitting recovery under a lesser degree of culpability than contemplated by the Legislature. This Court should, with equal vigor, insure that the Circuits are not now permitting recovery under a *higher* degree of culpability than contemplated by the Legislature.

This Writ should be granted for the simple reason that if it is not granted, the calm and unity occasioned by *Hochfelder* would quickly subside. No one was more familiar than this Court with the diverse standards which controlled the various Circuits before *Hochfelder:* some required scienter, some did not. That dispute is now ended, and a sense of unity and calm followed *Hochfelder*. However, a new dispute is now brewing on the issue of recklessness.

It has been shown above that plaintiffs are recovering, or not recovering, under different definitions of scienter. To refuse to decide the issue presented herein, is to erode the relative calm and unity offered by *Hochfelder,* and rekindle the failing sparks of disagreement and chaos under § 10 (b). This Court should terminate any escalating debate and disagreement over what the Court meant in footnote 12 of the *Hochfelder* opinion, and grant this Writ of Certiorari to resolve the issue and promote uniformity of decision among the Circuits on the definition of scienter.

CONCLUSION

Resolution of the issue presented herein would conclusively settle the problem of defining the "element of scienter" envisioned by this Court in the *Hochfelder* case. Failure to resolve the issue will foster further confusion among the Circuits and result in plaintiffs recovering, or not recovering, under different standards of proof; thus fostering injustice.

Respectfully submitted,

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APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEBRASKA

CV75-L-89

DANIEL L. SHULL,
Plaintiff,
vs.
DAIN, KALMAN & QUAIL, INC., a corporation, and HARRY WARE,
Defendants.

MEMORANDUM OF DECISION ON MOTION TO DISMISS

(Filed October 1, 1976)

Upon the plaintiff's resting his case after six days of trial without a jury during July and August, the defendants moved for a dismissal. After careful consideration of all the evidence, including extensive documentary exhibits, I conclude that the motion of each defendant must be granted.

Some factual findings have to be made in order to determine whether, if the defendants rested now without introducing any evidence, I could conclude that the preponderance of the evidence supported the plaintiff's position on any of the claims made. In that process I shall be weighing the evidence necessarily, because there is great conflict in the evidence offered on behalf of the plaintiff. Oral testimony from the defendant Ware and testimony by oral deposition of the defendant Ware were in direct collision with testimony by the plaintiff and his wife; although I cannot and need not resolve all those

conflicts by deciding which is correct, I shall make those findings of fact necessary to resolve the issue of whether the evidence now offered, if the defendants were to rest, would sustain by a preponderance of all the evidence any of the claims of the plaintiff and the issue of whether the statute of limitations bars the claims of the plaintiff.

Such findings of fact are contained within this memorandum.

Daniel L. Shull, the plaintiff, is a resident of Nebraska. Dain, Kalman & Quail, Inc. is a corporation having its principal office in Minneapolis, Minnesota, with branch offices in several cities, including Lincoln, Nebraska. It is registered as a broker-dealer of securities and is a member firm of the New York Stock Exchange and the National Association of Security Dealers, Inc.

Harry F. Ware is a resident of Lincoln, Nebraska, and at all times relevant to this action has been employed by Dain, Kalman & Quail, Inc. as a stockbroker and the manager of the Lincoln branch office of Dain, Kalman & Quail, Inc. He is a registered principal with the New York Stock Exchange.

The court has jurisdiction by reason of the Securities Act of 1933, as amended, 15 U.S.C. § 77v(a), the Securities Exchange Act of 1934, as amended, 15 U.S.C. & 78 (aa), and 28 U.S.C. § 1331(a). The amount in controversy exceeds $10,000.00, exclusive of interest and costs. Count IX arises under the law of Nebraska and the court assumes pendent jurisdiction over it. Count X has been dismissed without prejudice (filing 36).

The plaintiff is a chiropractor, who practiced his profession in Kansas and Colorado before moving to Lin-

coln, Nebraska, in 1967. While practicing in Colorado, he developed a professional relationship with a stockbroker in Salt Lake City, Utah, whereby the plaintiff customarily followed the stockbroker's advice regarding what stocks to buy and sell. During the years 1964 through 1969 the plaintiff made cash deposits with that stockbroker of approximately $60,000.00, which the stockbroker kept invested. The account was an aggressive growth-oriented one in which stocks were kept for short term profit and traded often. Some of the stocks in which investments were made were highly speculative. All this was in keeping with Shull's desire to make money. He was aware that risk was involved, although he did not learn through that stockbroker a great deal about the stock market and remained, essentially, an unsophisticated buyer of securities. By what he said to that stockbroker, the stockbroker had the impression that Shull's financial position was such that he could afford to speculate. That stockbroker continued to invest for Shull until about 1972.

In June, 1967, Shull and his wife decided to make additional investments through a stockbroker in Lincoln and contacted Harry F. Ware on the recommendation of one of Shull's patients. They told Ware of the Salt Lake City investments, told him the purpose of their investing was to make money, asked him to handle such investments as they decided to make through Ware and to treat their investment account as if it were Ware's own. Ware did not learn details of the plaintiff's income or net worth. Thereafter occasional investments of cash in various stocks were made throughout the next several years.

By no later than October, 1968, Shull had joined in Lincoln, Nebraska, an investment club, Handicappers No. 2, which consisted of eight members, who met monthly and invested $50.00 a month in securities. Harry F. Ware was the founder of the club and served as the elected secretary. Shull regularly attended the meetings where a variety of stocks were discussed and investments were made by majority vote. There were frequently divided votes. Typically, one or more members would give a report about a particular stock.

Beginning in 1971, Ware personally and Handicappers No. 2 began to invest in common stock of Home Builders, Inc. (Champion). During 1971 they both bought and sold Champion stock. In 1972 Ware personally and Handicappers No. 2 invested rather heavily in Champion stock, purchases by Handicappers No. 2 coming during the months of April, May, July, and August. Ware personally bought and sold Champion stock during 1972, having about $25,000.00 to $30,000.00 invested in it most of the time. In the early part of 1972, on the recommendation of Ware, Shull, between January 28 and July 28, sold other stock in the approximate amount of $73,000.00, purchased Champion stock in the approximate amount of $328,000.00, sold Champion stock in the approximate amount of $157,500.00, and bought other stock in the approximate amount of $20,000.00. Shull borrowed $20,000.00 from Nehawka Bank on June 17, 1972. During that period of time the price of Champion moved fairly steadily upward from 41 to a high of 125¾ on June 3, and then down gradually to 109½ on July 28. The foregoing purchasing was done with Shull and Ware knowing that the stock would split on a five-for-one basis on

July 31 and both expected the price to increase after the split. It did not do so, and on July 31 fell to 21 3/8 and from then until November 10, 1972, the price fluctuated between a high of 23 7/8 on August 2 and a low of 12¾ on November 10. On that date, November 10, 1972, the plaintiff purchased 2,500 shares of Champion at $13.00; on November 16, 1,000 shares at 12½; on November 20, 200 shares at 14¾; and on November 21, 1,400 shares at $15.00. These purchases probably were made with the approval, if not the positive recommendation, of Ware. At the end of November, 1972, Shull held about 13,850 shares of Champion.

Most, if not all, of the purchases of Champion by Shull between June 9, 1972, and November 21, 1972, were on margin. Although Ware apparently explained only the rudiments of a margin account to Shull and his wife, they at least understood that it meant that they were making some down payment on the purchase of the stock and the rest was being purchased on the credit of Dain, Kalman & Quail, thereby permitting them to purchase substantially more stock than they could if they paid cash for it all. Shull on August 1, 1972, borrowed from the National Bank of Commerce $20,000.00; on October 29, 1972, an additional $7,000.00; and on November 14, 1972, an additional $20,000.00. He borrowed $15,000.00 from Nehawka Bank on November 15, 1972. Ware was aware that Shull was borrowing this money for the purpose of purchasing stock, for the most part, and at the June 17, 1972, loan Ware took Shull to the Nehawka Bank in order that Shull might borrow from that bank. Nevertheless, none of these loans was arranged by Ware. He did not make the appointment, did not encourage the

banker to make the loan, and none of the loans was made on the strength of or because of anything Ware did.

In getting the June 17, 1972, loan from Nehawka Bank Shull gave a financial statement showing a net worth of $234,000.00. In connection with a National Bank of Commerce loan on August 1, 1972, Shull provided a financial statement showing a net worth of $357,896.00 and a salary of $70,000.00 annually. He did not admit to the National Bank of Commerce that he had borrowed $20,000.00 from Nehawka Bank.

Ware, previous to this, had been in Shull's home, which in 1972 had a value of approximately $47,000.00 and was beautifully furnished, knew that Shull owned other real estate of substantial value, and had held other stock of a somewhat speculative nature worth about $75,000.00, and had been told by Shull that as early as 1967 he was making $35,000.00 to $40,000.00 a year. Although Ware was lax to the point of carelessness in his learning the accurate details of Shull's financial condition in order to know whether a particular investment was suitable, I have no reason to think that if he had asked Shull in 1972 about his financial condition that he would have received any different or more unfavorable report than Shull gave to Nehawka Bank or the National Bank of Commerce.

During the calendar year 1973, Ware personally bought about $22,000.00 worth of Champion stock and sold none. Handicappers No. 3 (a new group, which had succeeded Handicappers No. 2 and which claimed Shull and Ware as members) owned 205 shares of Champion at the end of December, 1972, and sold all of it on January 17, 1973, for 12½ and 12 5/8, because the club was

dissolving. Handicappers No. 4, the successor to Handicappers No. 3, organized in April and purchased 60 shares of Champion in May at 6½ and held them throughout the year. Shull authorized Ware to sell Champion stock to meet a $10,000.00 margin call on February 2, 1973, but was angry that Ware sold 3,500 shares of Champion, because Shull could have paid the margin call in cash and did not understand that 3½ times the margin call had to be sold in stock. On February 20 he purchased 1,700 shares at 11 and on March 8, 1,700 shares at 8 5/8. On May 2 he purchased 1,500 shares at 6 5/8; on May 3, 2,300 shares at 6¼; on May 30, 3,900 shares at 5 7/8; on May 30, 100 shares at 5¾; and on June 4, 200 shares at 5¼. All the 1973 purchases were made from a cash account, not on margin, and were not solicited by Ware. Although Ware insists that he recommended against all these purchases, I am not persuaded that that is the case. His own investment in Champion in February, April, and August, 1973, and the investment of Handicappers No. 4, of which he was a member, suggest that he retained confidence in the ultimate recovery of the value of Champion stock. I think that the preponderance of the evidence is that throughout 1972 and 1973 Ware thought that Champion stock had great potential and, despite its almost continual course downward, he did not discourage the purchase of it. His early enthusiasm undoubtedly waned by late 1972, but I do not think, based only upon the evidence that is before me now, that he was recommending against the purchase of Champion in 1973, in view of Shull's supposed wealth.

Dain, Kalman & Quail, Inc. had a research department in 1972 that performed basic research on a number

of stocks. Those stocks which were followed by Dain, Kalman & Quail's research department were "recommended." Champion was not followed by the research department and consequently was not "recommended." It is probably true that Ware did not specifically inform Shull that Champion was not "recommended." On November 20, 1972, however, he sent a letter to all members of Handicappers No. 3, including Shull, castigating them for not taking advantage of Dain, Kalman & Quail's "research recommended stocks," saying that "Sony Graco, Iowa Beef Packers and DKQ" were "the only research recommended stocks that we own." At that time, as all members knew, the club owned Champion stock. At the meeting of December 5, 1972, of Handicappers No. 3, Ware discussed the stocks which were "suggested as buys from the Dain research organization." Shull was present at that meeting. At least it must be said that no later than November or December, 1972, Shull was aware that Champion was not followed by the Dain, Kalman & Quail research department and therefore was not "recommended." And it cannot be said that any failure specifically to talk to Shull about research-followed stock was indicative of any fraudulent intent on Ware's part.

During 1972 and perhaps in 1973, Ware told Shull, as well as others to whom he recommended the purchase of Champion stock, that Home Builders, Inc. had more orders than it could fill, that he knew some of the officers of the company, that he was investing in Champion stock himself, and said that he was borrowing money in order to buy Champion stock. He did not tell Shull that he from time to time also sold portions of his Champion stock. In fact, Ware did not know any of the officers

of Home Builders, Inc. None of the other statements made by Ware to Shull has been shown to be untrue, and I am persuaded that if Ware had told Shull during any time in 1972 or 1973 that he, Ware, was selling from time to time portions of his Champion stock, that fact would not have influenced Shull to do differently. From time to time Ware told Shull that he thought that Champion stock had "bottomed out." He was mistaken, but it was not a knowing misstatement.

Nothing Ware did was for a fraudulent purpose.

COUNT I

This count is based upon § 12 (2) of the 1933 Act, 15 U. S. C. § 77 (1) (2), which provides for civil liability of one who offers or sells a security by use of a communication which includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements not misleading. The statute of limitations is one year after discovery by the purchaser of the untrue statement or omission or after discovery should have been made. The only untrue statement of a material fact or omission of a material fact upon which liability under this count could be predicated is the statement of Ware that he knew the officers of Home Builders, Inc., and omitting to tell Shull that he, Ware, was from time to time selling portions of his own Champion holdings and failure to tell Shull that Champion stock was not followed by the Dain, Kalman & Quail research department. As to each of those, Shull did discover or should have discovered the untrue statement or omission more than one year before June 5, 1975, the date of the filing of the complaint in this action.

By mid-June, 1973, the price of Champion stock had skidded to $4.00 a share and there is no indication that it substantially recovered thereafter. Shull had lost perhaps $100,000.00. Shull's wife, an active participant in Shull's financial affairs, had lost confidence in Ware. Yet Shull made no effort to learn whether what Ware had told him as being factually true was true. If he was relying to any degree upon Ware's saying that he knew the officers of the company, Shull by mid-1973 could not possibly have placed any reliance upon such a statement as giving any validity to an assessment of the virility of the company. If Shull was relying upon his impression that Ware was not selling his own Champion stock, he provided Ware no reason to think that he was relying thereon. He made no effort to find out whether Ware was holding all the stock he had purchased. Ware in fact continued to hold stock of a fairly substantial amount in Champion throughout 1972 and 1973. He in fact retained an impression that investing in Champion was not unwise, at least for one in a high income bracket who had substantial other holdings and could hold the stock for an extended period of time. As to the fact that Champion stock was not followed by the research department, this was either known or should have been known by Shull as early as November or December, 1972, from both oral and written communications made by Ware.

Accordingly, Count I is barred by the statute of limitations.

COUNT II

This count rests upon § 17 of the 1933 Act, 15 U. S. C. § 77q. This statutory section, however, does not provide

a separate civil remedy. The remedy is in § 12 (2), which has been pleaded in Count I in the complaint, as discussed in the preceding section of this memorandum. The court in *Greater Iowa Corp. v. McLendon*, 378 F. 2d 783 (C. A. 8th Cir. 1967), said:

> "The intent of Congress is clear. Section 12 provides a private, civil remedy to 'purchasers.' We think this is the civil remedy given to private parties by the framers of the Act, and excludes establishment of additional private civil remedies. Had Congress desired to extend the private civil remedy it could have done so by the addition of only a few words."

Cases since that time have not overturned that pronouncement. Accordingly, Count II must be dismissed for failure to state a claim upon which relief can be granted.

COUNT III

Section 9 (a) (4) of the 1934 Act, 15 U. S. C. § 78i (a) (4), makes unlawful the making of false or misleading statements of material facts by a dealer or broker. The remedy is limited to that set out in 15 U. S. C. § 78i (e), which provides:

> "Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction . . ."

The difficulty is that liability exists if the purchase or sale was "at a price which was affected by such act or transaction"—that is, by the false or misleading statement or the sale or purchase resulting from that false or misleading statement. There has been no evidence offered in this case to the effect that any false or misleading state-

ment of Ware affected the price of Champion stock or any other stock.

The count, therefore, must be dismissed for inadequacy of proof.

COUNT IV

The plaintiff's primary thrust is rooted in Rule 10 (b) 5 of the Securities and Exchange Commission (17 C. F. R. § 240.10 (b) (5)) and § 10 (b) of the Securities and Exchange Act of 1934 (15 U. S. C. § 78j (b)). The applicable portion of 15 U. S. C. § 78j is:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, . . .—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10 (b) 5 of the Securities and Exchange Commission states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

In order for the plaintiff to recover upon the basis of untrue statements or omissions of the material facts under this rule, it is necessary that the plaintiff prove, among other things, that the untrue statement or omission was made with an intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, — U. S. —, 47 L. Ed. 2d 688 (1976). As earlier found, the plaintiff has not established by a preponderance of the evidence now before the court that any misstatement of fact or failure to state a fact was made with intent to deceive, manipulate, or defraud.

Count IV, therefore, must be dismissed for failure of proof.

COUNT V

This claim charges that there was an illegal "arranging for the extension of credit to the plaintiff," in violation of § 7 of the 1934 Act (15 U. S. C. § 78g (c)) and Regulation T of the rules promulgated by the Board of Governors of the Federal Reserve System (12 C. F. R. § 220) and causing a violation of § 7 of the 1934 Act (15 U. S. C. § 78g (d)) and Regulation U of the rules promulgated by the Board of Governors of the Federal Reserve System (12 C. F. R. § 221).

This claim is not factually supported, because the preponderance of the evidence does not establish that Ware arranged for credit within the meaning of the Act.

COUNTS VI, VII AND VIII

These counts allege violation of rules adopted by the New York Stock Exchange, pursuant to Sections 6 and 19 of the 1934 Act (15 U. S. C. §§ 78f and 78s), which rules require the use of diligence in learning essential facts relative to customers, the diligent supervising by member organizations of registered representatives of the member organization, and the obtaining of reasonable grounds for believing that a recommendation is suitable for a customer on the basis of facts before making a recommendation for the purchase or sale of a security.

My conclusion is that no private remedy may be implied for violations of such rules. I adopt the reasoning of Judge Stuart in *Piper, Jaffray & Hopwood Incorporated v. Ladin,* 399 F. Supp. 292 (U. S.D. C. S. D. Ia. 1975). These three counts, therefore, must be dismissed for failure to state a claim upon which relief can be granted.

COUNT IX

The plaintiff asserts liability under the Securities Act of Nebraska, § 8-1101 et seq., Neb. R. R. S. 1943, as amended. The statutory provision is almost precisely the same as the federal statute under which Count I is pleaded. The statute of limitations contained in § 8-1118 is somewhat different. The Nebraska statute declares that "No person may sue under this section more than two years after the contract of sale." Because the complaint in this

matter was filed on June 5, 1975, it means that no action lies for any sale made or contracted for before June 4, 1973. The last sale of Champion stock to Shull was on May 30, 1973. Accordingly, the statute of limitations has run on the claim contained in Count IX.

COUNT XI

This count asserts fraud. As previously held, the evidence does not support a charge of fraud.

Dated September 30, 1976.

BY THE COURT
/s/ Warren K. Urbom
Chief Judge

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 76-1935

DANIEL L. SHULL,

Appellant,

vs.

DAIN, KALMAN & QUAIL, INC., a corporation, and HARRY WARE,

Appellees.

Appeal from the United States District Court for the District of Nebraska

Submitted: May 18, 1977

Filed: August 26, 1977

Before BRIGHT and HENLEY, Circuit Judges, and BENSON, Chief District Judge.*

HENLEY, Circuit Judge.

During 1972 and 1973 plaintiff, Daniel L. Shull of Lincoln, Nebraska, speculated heavily in a certain corporate stock, referred to in the record and briefs as Champion Home Builders stock (Champion). In 1972 he bought largely on margin and borrowed large sums of money from Nebraska banks to make the required down payments and meet margin calls. During most of the first half of 1972 the price of the stock rose sharply; it then fell dramatically and continued to fall throughout 1973. Plaintiff dealt with the brokerage firm of Dain, Kalman & Quail, Inc (DKQ) of Minneapolis, Minnesota; his actual dealings were with Harry Ware, DKQ's branch manager in Lincoln. On June 5, 1975 plaintiff commenced this action in the district court against DKQ and Ware seeking to recover damages to compensate him for his losses.

The complaint, as amended, was in eleven counts and was broadly based. It was alleged that Ware and DKQ, acting through Ware, violated: (1) The Securities Act of 1933, 15 U. S. C. §§ 77a *et seq.;* (2) the Securities Exchange Act of 1934, 15 U. S. C. § 78a *et seq.;* (3) Rule 10(b) (5) of the Securities & Exchange Commission, 17 C. F. R. § 240.10(b) (5); (4) Regulation "T" of the Board of Governors of the Federal Reserve System issued pursuant to § 7 of the 1934 statute that has been mentioned; (5) certain rules of the New York Stock Exchange and

* The Honorable Paul Benson, Chief District Judge, District of North Dakota, sitting by designation.

of the National Association of Security Dealers issued pursuant to §§ 6, 15A and 19 of the 1934 statute; (6) the Nebraska Securities Act, Neb. R. R. S. §§ 8-1101 *et seq.*, as amended. Plaintiff also alleged that the defendants had been guilty of common law fraud, deceit, negligence and breach of fiduciary duty. No question has been raised as to federal subject matter jurisdiction, and such jurisdiction is established.

The tenth count of the complaint which charged negligence and breach of duty was dismissed without prejudice. The remaining counts were tried without a jury before Chief District Judge Warren K. Urbom. At the conclusion of plaintiff's case the defendants moved for judgment pursuant to Fed. R. Civ. P. 41 (b). On September 30, 1976 the district court filed a full memorandum opinion, granted the defense motion, and dismissed Counts I-IX and XI of the complaint with prejudice. This appeal followed.

Rule 41 (b) provides that after a plaintiff has completed his case in the course of a nonjury trial, the defendant, without waiving his right to introduce evidence should his motion be denied, may move for judgment on the ground that the plaintiff has shown no right to relief. If such a motion is made, the trial court, as trier of the facts, is to determine them and may render judgment against the plaintiff or may decline to render any judgment until the close of all of the evidence. If the motion is granted, the trial court is required to make findings as required by Rule 52 (a).

Speaking of the standard that a district court is required to apply in passing on a Rule 41 (b) motion and

the review standard that we apply in passing upon the action of a district court in granting such a motion, we said recently in *Lang v. Cone*, 542 F. 2d 751, 754 (8th Cir. 1976):

> The function that a trial judge performs in passing upon a Rule 41 (b) motion in a nonjury case is not the same as the function that a trial judge performs in the course of a jury trial when he is called upon to rule on a defense motion for a directed verdict at the close of the plaintiff's case or at the close of all of the evidence. In the latter case the judge simply decides whether there is substantial evidence to take the case to the jury, and in making that determination he is required to view the evidence in the light most favorable to the plaintiff, and to give the plaintiff the benefit of all favorable inferences reasonably to be drawn from the evidence. In a Rule 41 (b) situation, however, the district court may find the facts itself and may render judgment against the plaintiff if the court considers that plaintiff has not made out a case, and if the district court sustains the Rule 41 (b) motion, its findings will not be reversed on appeal unless clearly erroneous. *Smith v. South Central Bell Telephone Co.*, 518 F. 2d 68 (6th Cir. 1975); *Taylor v. Honeywell, Inc.*, 497 F. 2d 1382 (10th Cir. 1974); *Palmentere v. Campbell*, 344 F. 2d 234 (8th Cir. 1965); 9 Wright and Miller, Federal Practice & Procedure, § 2371.

It is familiar law, of course, that a factual finding of a district court is "clearly erroneous" if it is not supported by substantial evidence or, even though there be substantial evidence to sustain it, the reviewing court is clearly satisfied that a mistake has been made. However, it is not the function of an appellate court to try the case de novo, or to pass upon the credibility of witnesses or on the weight to be given to their testimony, and a

finding is not clearly erroneous simply because a different result might have been reached had the case been tried originally to the appellate court. However, a factual finding that is based upon the application of an erroneous legal standard cannot be upheld. *See* in general *Zenith Radio Corp. v. Hazletine Research, Inc.*, 395 U. S. 100 (1969); *United States v. United States Gypsum Co.*, 333 U. S. 364 (1948); *United States v. Wright*, 428 F. 2d 445 (8th Cir. 1970); *Minneapolis, St. Paul & S. S. M. R. Co. v. Metal-Matic, Inc.*, 323 F. 2d 903 (8th Cir. 1963); *Republic Rice Mill, Inc. v. Empire Rice Mills, Inc.*, 313 F. 2d 717 (8th Cir. 1963); *Blackhawk Hotels Co. v. Bonfoey*, 227 F. 2d 232 (8th Cir. 1955); *Noland v. Buffalo Ins. Co.*, 181 F. 2d 735 (8th Cir. 1950); *Hudspeth v. Esso Standard Oil Co.*, 170 F. 2d 418 (8th Cir. 1948). *See also* 9 Wright and Miller, Federal Practice & Procedure, §§ 2585-86, pages 729-40.

Before going further, we find it desirable to refer to the individual counts of the complaint since an advance familiarity with those counts should make our statement of the facts and discussion of the issues a good deal more intelligible.

Count I alleged a private civil action based on an alleged violation of § 12(2) of the Securities Act of 1933, 15 U. S. C. § 77 *l* (2). That statute imposes liability on anyone who offers or sells a security by use of a communication that includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements that have been made not misleading. Suit under § 12(2) must be filed within one year after the injured party discovers the misstatement or omission or

should have discovered it by the exercise of ordinary care. 15 U. S. C. § 77m.

Count II alleged a violation of § 17(a) of the 1933 Act 15 U. S. C. § 77q(a). Section 17(a) makes it unlawful for one to employ fraudulent or deceptive devices in connection with the sale of securities. However, it does not confer in terms a private cause of action in favor of a person who purchases a security that has been sold to him in violation of the section. In *Greater Iowa Corp. v. McLendon*, 378 F. 2d 783, 788-90 (8th Cir. 1967), we held that the private remedy of a purchaser must be found in § 12(2) and not in § 17(a).

Count III was based on § 9 of the 1934 Act, 15 U. S. C. § 78i. Section 9(a)(4) makes it unlawful for any dealer, broker or other person selling or offering to sell a security to make a statement about it which he knows to be false or misleading or which he had reasonable grounds to believe was false or misleading. And § 9(e) creates a private cause of action in favor of a person who has suffered damage as a result of purchasing a security at a price that had been affected by a violation of § 9(a).

The district court thought that the primary thrust of plaintiff's claim was to be found in Count IV which was based on § 10(b) of the 1934 Act and on Rule 10(b)(5) of the Securities & Exchange Commission. In relevant part, the Rule, which accords with the statute, is as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any devise, scheme, or artifice to defraud,

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In *Ernst & Ernst v. Hochfelder,* 425 U. S. 185 (1976), the Supreme Court held that a suit based on § 10(b) and Rule 10(b)(5) cannot be successfully maintained on the basis of negligence alone, and that in order to prevail a plaintiff must show scienter, that is to say a fraudulent, deceptive or manipulative intent.

In Count V plaintiff claimed a violation of Regulation "T" of the Board of Governors of the Federal Reserve System (Federal Reserve Board), 12 C. F. R., Part 220, that was issued pursuant to the authority conferred by § 7(c) of the 1934 Act, 15 U. S. C. § 78g(c). That section and § 7(d), 15 U. S. C. § 78g(d), authorize the Board to restrict margin transactions on the stock market and to impose credit controls on brokers, dealers and others, including banks. The credit controls imposed on brokers and dealers are to be found in Regulation "T", and those imposed on banks are to be found in Regulation "U", which appears as 12 C. F. R., Part 221.[1]

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1 Count V refers to both Regulation "T" and Regulation "U." However, plaintiff is not seeking any relief against any of the banks from which he borrowed money, and it appears to us that his allegations of Regulation "U" violations are relevant only as they may bear upon the Regulation "T" violations upon which he relies.

When Regulation "T" and Regulation "U" are read together, it appears that while a stock broker may to a limited extent give credit to his margin customers or arrange for an extension of credit to them by others, a broker violates Regulation "T" if he "arranges" for a bank to extend credit to a margin customer in violation of that part of Regulation "U" which appears as 12 C. F. R. § 221.1(a). It appears that if a violation of Regulation "T" causes the offending broker's customer to suffer damage, the customer has a cause of action against the broker. *Perlstein v. Scudder & German*, 429 F. 2d 1136 (2d Cir. 1970), *cert. denied*, 401 U. S. 1013 (1971); *Junger v. Hertz, Neumark & Warner*, 426 F. 2d 805 (2d Cir.), *cert. denied*, 400 U. S. 880 (1970). Similarly, a customer has a cause of action against a bank which has made a loan to him in violation of Regulation "U". *See Goldman v. Bank of Commonwealth*, 467 F. 2d 439 (6th Cir. 1972).

Counts VI, VII and VIII alleged, respectively, violations of Rule 405 and Rule 342 (a) of the New York Stock Exchange and Article III, § 2 of the Rules of Fair Practice of the National Association of Security Dealers.

The Stock Exchange Rules were promulgated under §§ 6 and 19 of the 1934 Act, 15 U. S. C. §§ 78f and 78s, and the Association's Rules were issued as provided by 15 U. S. C. § 78o-3 which was added to the 1934 Act in 1938.

Exchange Rule 405 requires every member of the Exchange to learn essential facts about all customers and to supervise diligently all accounts handled by registered representatives of the organization. Rule 342 (a) requires proper supervision by members of the conduct and operations of employees.

The Association Rule that has been mentioned requires that in recommending a security transaction to a customer the member shall have reasonable grounds for believing that the recommendation is suitable for the customer on the basis of facts, if any, disclosed by the customer with respect to his other security holdings and with respect to his financial status and needs.

Count IX was based on the Nebraska Securities Act that has been cited. That statute closely resembles the 1933 federal Act, but unlike the federal Act it has a two year statute of limitation.

As stated, Count X was dismissed without prejudice, and a cause of action based on that count may now be pending in the state courts.

Count XI alleged common law fraud and deceit in addition to the comon law charge of negligence and breach of duty that had been incorporated in Count X.

The historical and background facts of the case are set out in considerable detail in the opinion of the district court. Although the defendants put on no proof at the trial of the case, the plaintiff called Ware as an adverse witness and also introduced his discovery deposition. The evidence that the district court heard was sharply conflicting in certain areas, and Judge Urbom did not try to resolve all of the conflicts. It seems to us, however, that many of the facts are essentially undisputed.

Turning now to those facts, we will say, first, that DKQ is a licensed broker-dealer in securities and is a member of the New York Stock Exchange and of the National Association of Security Dealers. The defendant,

Ware, is listed with the New York Stock Exchange as a "registered principal." The Champion stock with which we are concerned was a duly registered security. In those circumstances, DKQ and Ware were, of course, subject to the statutes, rules and regulations that have been mentioned. No claim is made that in his dealings with the plaintiff Ware was acting otherwise than in the course and scope of his employment as DKQ's managing agent in Lincoln.

The plaintiff, Dr. Daniel L. Shull, is a practicing chiropractor and is apparently a successful one. He and his wife moved to Lincoln in 1967 and acquired a substantial home which was well furnished. Their life style was calculated to create the impression that they were people of substantial means. Prior to moving to Lincoln, Dr. Shull had lived in Colorado and perhaps in Kansas.

For a number of years prior to the period involved in this case plaintiff and his wife had habitually invested in corporate stocks, including some rather highly speculative ones. For a substantial period of time they dealt with a stock broker in Salt Lake City; he had no real knowledge of their financial status but gained the impression that they were wealthy people and could afford to play the market. It appears that plaintiff and Mrs. Shull placed substantial sums in the hands of that broker for investment. Plaintiff claims, however, that until he began to deal with Mr. Ware he had never bought any stocks on margin, and the district court found that in 1972 and 1973 plaintiff was actually what is commonly called an "unsophisticated investor." Plaintiff was introduced to Ware by a patient in 1967.

Thereafter plaintiff began to buy and sell stocks through Ware although plaintiff still maintained his relations with the Salt Lake broker for some years. Ware was told that plaintiff and his wife desired to make money out of their stock purchases, that they wanted Ware to handle their business, and that he should deal with their money as though it were his own. Ware never undertook to make any detailed investigation of plaintiff's financial situation; however, he visited in plaintiff's home and was aware of certain other assets owned by plaintiff. Like the broker in Salt Lake City, Ware seems to have assumed that plaintiff was a wealthy man and could afford to be in the market. At no time did the plaintiff do or say anything to dispel that belief.

In October, 1968 plaintiff joined an investment club that had been formed by Ware and of which Ware was the elected secretary. The name of this club was Pacesetters No. 2; it was succeeded by Pacesetters No. 3, and still later by Pacesetters No. 4. The club had eight members who met once a month. At each meeting each member would contribute $50.00 to a pool, and stocks would be bought in accordance with the wishes of a majority of the members. At the meetings various stocks would be discussed, and individual members would give reports on particular stocks.

In 1971 Pacesetters No. 2 and Ware personally began to invest in Champion stock in which Ware had great confidence. During 1972 Ware both bought and sold the stock for his own account and usually had between $25,-000.00 and $30,000.00 of his own money invested in it.

The record reflects that DKQ maintained a research service that followed and recommended certain stocks to customers. That service never followed or recommended Champion stock. However, not much importance is to be attached to that fact in itself.

There is no doubt that during 1972 Ware was pushing the stock in question and was making certain representations about his knowledge of the affairs of the issuing company which were not altogether true. For example, he stated that he was personally acquainted with some of the officers of the company which was not the case.

The district court found, and the record reflects, that plaintiff on Ware's recommendation began to buy and sell Champion stock in 1972. Purchases made by plaintiff between late January and early June appear to have been for cash.

During the seven month period from January 28 to July 28, 1972 the price of the stock rose sharply from \$41.00 per share to \$125.75 per share on June 3; as of July 28 it was down to \$109.50. Shull and Ware knew that the stock was to be split five-for-one on July 31 and hoped that the split would increase the price of the stock. It did not do so, and the price declined steadily and rapidly throughout the rest of 1972 and into 1973.

Plaintiff began to purchase Champion stock on margin in June, 1972 and continued to do so for the rest of the year. Plaintiff also bought Champion stock for cash in 1973; the 1973 purchases were not on the recommendation of Ware. Plaintiff made his last purchase of

Champion stock on June 4, 1973 and paid \$5.25 per share for it.

As stated, during 1972 Ware both bought and sold Champion stock for his own account. In early 1973 he bought a substantial number of shares and sold none during that year.

Plaintiff financed his 1972 margin transactions largely by means of bank loans. His first loan in the sum of \$20,000 was made in June, 1972 by the Nehawka Bank of Nehawka, Nebraska; he also borrowed from the First National Bank & Trust Company, the National Bank of Commerce and Citibank & Trust Co., all of Lincoln, and he made a loan from the Martell State Bank of Martell, Nebraska. The proceeds of those loans were used to make down payments on margin stocks and to meet margin calls as the price of Champion stock fell. Whether Ware "arranged" those loans in violation of Regulation "T" is an important issue in the case.

As has been seen, plaintiff's complaint set out a number of bases of recovery, a principal one of which was that in inducing plaintiff to buy Champion stock on margin Ware had been guilty of what may generally be called "fraud," that is to say, that Ware had intentionally made misstatements of material facts and had failed to disclose material facts that he ought to have disclosed. And Counts I, II, III, IV, IX and XI were ultimately based on fraud.[2]

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2 It will be recalled that Count V was based on alleged violations of Regulation "T," and Counts VI, VII and VIII were based on alleged violations of Stock Exchange and Association Rules.

Plaintiff claimed that Ware urged and induced plaintiff to buy the stock without adequately looking into questions of plaintiff's situation and needs and without adequately investigating the issuing company. Plaintiff also claimed that Ware made some positive misrepresentations and was guilty of certain nondisclosures, namely, that Ware told plaintiff that Ware was buying large blocks of Champion stock in approximately the same amounts as those he was recommending to the plaintiff; that Ware had inside information about the affairs and organization of the issuing company; that it was a legal and common practice for individuals situated as was plaintiff to borrow money to buy stocks on margin, and that Ware was doing the same thing himself; and that when the price of the stock began to decline, Ware represented that he was losing large amounts of money and that he was borrowing from banks and mortgaging his assets in order to hold the stock. Other claims were that Ware failed to disclose to plaintiff and other members of the investment club that DKQ was not following the stock and had not recommended it to its customers, and that Ware did not disclose to plaintiff in 1972 that Ware was selling Champion stock as well as buying it for his own account.

The district court discussed the subject of fraud in some detail in its general consideration of the facts of the case and mentioned it in connection with certain particular counts.

The district court found ultimately that while Ware may have been negligent and while he may have been overenthusiastic in his endorsement and recommendation of Champion stock in 1972 if not in 1973, he had not acted dishonestly or with any fraudulent, deceptive or manipulative

intent, and that the plaintiff had not carried his burden of proof on the fraud issues.

In fairness to the plaintiff we will say that the evidence did not require the district court to resolve the fraud issues adversely to plaintiff, and that the decision might well have gone the other way. We are not able to say, however, that the findings of the district court were not supported by substantial evidence or that they were clearly erroneous.

The district court's finding that no fraud or scienter had been proved by a preponderance of the evidence was dispositive of Count IV and of Count XI, and nothing further need be said about those counts. Some discussion as to the remaining counts is necessary.

As to Count I the district court concluded that assuming that Ware had made false statements or had failed to make proper disclosures, plaintiff was aware of the true facts or should have been aware of them substantially more than a year prior to the filing of the suit, and that Count I was barred by the one year limitations period set out in § 13 of the 1933 Act, 15 U. S. C. § 77m. As to Count IX, which was based on the Nebraska Securities Act, the district court found that plaintiff's last purchase of the Champion stock had been made more than two years prior to the filing of the suit, and that Count IX was barred by limitations. We are of the opinion that the factual findings underlying the dispositions of those counts were not clearly erroneous, and that no error was committed when those counts were dismissed.

Count II was dismissed on the ground that § 17(a) of the Act gives no private cause of action. We agree. *Greater Iowa Corp. v. McLendon, supra.*

Count III went out because there was no evidence that the conduct or representations of Ware had affected the price of Champion stock in any way. Again we agree.

We will pass over Count V for a moment and turn our attention to Counts VI, VII and VIII based on the violations of the Rules of the New York Stock Exchange and of the National Association of Security Dealers. For purposes of discussion we will assume that DKQ and Ware in fact violated all three of the Rules invoked by plaintiff.

The question of whether a violation of a private stock exchange or trade association rule, required to be promulgated by federal law, such as a rule of the New York Stock Exchange or the National Association of Security Dealers, gives rise to a private cause of action in favor of a customer or trader who is damaged as a result of the breach is a troublesome one. It was before us recently in the context of an alleged breach of a rule of the Chicago Mercantile Exchange in *Lincoln Commodity Services v. Meade,* — F. 2d — (8th Cir. No. 76-1924 July 11, 1977), and we found that no private cause of action had been established in that case. Speaking of the question generally we said (slip opinion, p. 9, n. 1):

> Some courts have suggested such a right of action for violations of securities exchange rules. *Colonial Realty Corp. v. Bache & Co.,* 358 F. 2d 178 (2d Cir.), *cert. denied,* 385 U. S. 817 (1966); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 410 F. 2d 135, 141 (7th Cir.), *cert. denied,* 396 U. S. 838 (1969). It has been argued that the same sort of right ought to be available where there are violations of the rules of contract markets upon which commodities are traded. *See, e. g.,* Note, Private Rights of Action for Commodity Futures Investors, 55 B. U. L. Rev. 804-26 (1975).

> However, courts have not usually recognized a private right of action for violations of exchange rules in the absence of a finding of fraud. *See, e. g., Carras v. Burns,* 516 F. 2d 251, 260 (4th Cir. 1975); *Evans v. Kerbs & Co.,* 411 F. Supp. 616, 624 (S. D. N. Y. 1976). In the instant case there was no finding of fraud.

Since the district court permissibly found that plaintiff had failed to prove fraud on the part of the defendants, we conclude that no error was committed when Counts VI, VII and VIII were dismissed.

There remains for consideration the question of the propriety of the action of the district court in dismissing Count V of the complaint which alleged violations by Ware of Regulation "T" of the Federal Reserve Board, upon which regulation we have commented to some extent already.

The plaintiff contends that the loans that he obtained from banks in 1972 were made in violation of Regulation "U," and that Ware had "arranged" them in violation of Regulation "T." The defendants contend that the loans involved no violations of Regulation "T" by Ware, and that in any event Ware did not "arrange" for the loans to be made to the plaintiff.

The trial judge found that Ware had not arranged the loans and evidently considered it unnecessary to decide whether the credit extensions involved violations of Regulation "T" or Regulation "U," or both. For purposes of discussion we will assume that the loans were illegal, and will confine ourselves to the question of whether Ware "arranged" for the loans to be made and so violated Regulation "T".

Neither the 1934 statute nor the regulations of the Federal Reserve Board defines the term "arrange for the extension or maintenance of credit" or the terms "arrangement" or "arranging." It is obvious that a broker may be involved in various ways and to various extents in a loan made by a third person, including a bank, to one of the broker's customers, and it may not always be easy to determine whether in a particular case the broker "arranged" the loan and so violated the Regulation.

Either one of two extreme views can be taken. It can be argued that a broker has arranged for an extension of credit to his customer if the former has participated in the credit transaction in any way. On the other hand, it can be urged that a broker has not arranged a loan or extension of credit unless he was the procuring cause of it, or unless but for the efforts of the broker the loan would not have been made.

Both of those views were pressed upon the court in *Alaska Interstate Co. v. McMillian,* 402 F. Supp. 532, 553-58 (D. Del. 1975), a case which counsel for plaintiff has earnestly recommended to our attention. After taking note of the existence of the two extreme views and after observing that it thought that the "but for" view was "closer to the mark," the district court found itself unable to accept either view. 402 F. Supp. at 554. After discussing the problem, the court seems to have come to the conclusion that the question of whether an extension of credit had been "arranged" by a broker or dealer depends for its answer "on the degree of the broker's participation and its propensity to cause an extension of credit in a situation where credit might not otherwise be

extended." 402 F. Supp. at 555. The court felt that an "arranging" would be shown if it appeared that the broker had initiated the contract between the customer and the lender or had participated in the loan negotiations, but that a "less direct involvement without some further causal relationship" would not suffice. 402 F. Supp. at 556. And it seems to us that regardless of the standard to be employed the question in each case is ultimately one of fact.

We have carefully considered the evidence in the case bearing on this particular issue mindful that the burden was on the plaintiff to establish by a preponderance of the evidence that Ware arranged the respective loans, that plaintiff was not entitled to have his testimony taken at face value and was not necessarily entitled to have the evidence viewed in the light most favorable to him.

There is no evidence that Ware participated in the negotiations of any of the several loans that were made to plaintiff, and there is no satisfactory evidence that the loans would not have been made "but for" participation by Ware in the over-all transactions. As to whether Ware initiated the contacts between plaintiff and the respective banks, assuming that such initiation would constitute an "arranging," the case is much closer, and the first loan to plaintiff which was made by the Nehawka Bank is particularly suspect since it seems clear that Ware drove plaintiff to that bank in Ware's automobile and introduced plaintiff to the bank official who made the loan. And there was evidence on the part of the plaintiff to the effect that with respect to the other bank loans Ware indicated to plaintiff the banks upon which he

should call, and that on one occasion a bank officer telephoned Ware to express appreciation for having been sent plaintiff's business.

On this phase of the case the trial judge found that Ware knew that plaintiff was borrowing money to buy stock, and that Ware took plaintiff to the Nehawka Bank in June, 1972 "in order that Shull might borrow from that bank." However, that statement in the opinion is followed immediately by this one: "Nevertheless, none of these loans was arranged by Ware. He did not make the appointment, he did not encourage the banker to make the loan, and none of the loans were made on the strength of or because of anything Ware did." And in dealing with Count V specifically the district court said: "This claim is not factually supported because the preponderance of the evidence does not establish that Ware arranged for credit within the meaning of the Act."

As in the case of the fraud issues, we think that the decision of the trial court could easily have gone the other way, but we are not prepared to say that the trial court's finding stemmed from an improper view of the law or that it was clearly erroneous.

In view of what has been said, it follows that the judgment of the district court is affirmed.

A true copy.

Attest:

CLERK U. S. COURT OF APPEALS,
EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1977

76-1935

DANIEL L. SHULL,

Appellant,

vs.

DAIN, KALMAN & QUAIL, INC., ETC., ET AL.,

Appellees.

Appeal from the United States District Court
for the District of Nebraska

Petition of appellant for rehearing filed in this cause having been considered, it is now here ordered by this Court that the same be, and it is hereby, denied.

September 26, 1977

IN THE

Supreme Court of the United States

October Term, 1977

No. 77-904

DANIEL L. SHULL,

Petitioner,

vs.

DAIN, KALMAN & QUAIL, INC. and HARRY WARE,

Respondents.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

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ARGUMENT

The Petition for Certiorari should be denied because:

I. There Are No Special And Important Reasons Why Review On Writ of Certiorari Should Be Granted.

The petitioner-plaintiff suggests that certiorari should be granted because the trial court and the Eighth Circuit made an erroneous ruling on the nature of scienter required by *Hochfelder v. Ernst & Ernst*, 425 U.S. 95 (1976). Specifically, the petitioner claims that the courts below held that proof of recklessness was insufficient to satisfy the scienter required in a 10b-5 case since *Hochfelder*. In fact, however, the trial court made no such ruling because the issue was never raised in the trial court,[1] and it was unnecessary to consider the issue because of a total failure of proof by plaintiff of any actionable negligence, much less fraud. The findings of the trial court below were, as the Eighth Circuit stated quite clearly in its opinion, primarily findings on factual issues. There were no hotly contended legal issues, no finding that recklessness is an inappropriate standard. The case turned simply on the trial court's disbelief of plaintiff's case in chief.

Throughout these findings, it is clear that the court distrusted the testimony of plaintiff Dr. Shull, a chiropractor who made large stock purchases in cash of small denominations, gave admittedly irregular and inaccurate financial statements, had a history of speculative trading, and created an image of wealth in the community.

The trial court, given this distrust, had found "great

[1]Plaintiff did not cite *Hochfelder* in its initial trial brief.

conflict" in plaintiff's evidence and, after weighing it, granted defendants' motion to dismiss at the close of plaintiff's case, including with its order an extensive memorandum. Among the court's findings was a holding that there had been no "fraud" and that "nothing Ware did was for a fraudulent purpose." App. at 9.

That was, however, not the only critical finding by the trial court. It also found that there were no proximately caused damages even if there had been carelessness by defendant Ware. Although the trial court found possible "laxity" in learning the "details" of plaintiff's financial condition, it said that laxity was immaterial, finding that Shull would not have told defendants the full truth about his financial condition in any case. Finally, the court found no reliance at critical points by Dr. Shull, App. 10, lack of materiality as to any possible misrepresentation, App. 9, and failure to comply with applicable statutes of limitations. There was no finding of recklessness by either the trial court or by the Eighth Circuit, nor did plaintiff ask the court to make such a finding under Fed. R. Civ. P. 59(a).

In short, there has been no compliance with Rule 19-1 of the Rules of the Supreme Court, which specifies that review by writ of certiorari "should be granted only where there are special and important reasons therefor." In *Rice v. Sioux City Cemetery*, 349 U.S. 70, 74 (1955), the Court discussed the "substance" necessary to grant certiorari:

> A federal question raised by a petitioner may be "of substance" in the sense that, abstractly considered, it may present an intellectually interesting and solid problem. But this Court does not sit to satisfy the scholarly interest in such issues. Nor does it sit for

> the benefit of the particular litigants. . . . "Special and important reasons" imply a reach to a problem beyond the academic or episodic.

This was, in all fairness to petitioner-plaintiff, a garden variety Rule 10b-5 case, with a somewhat more colorful plaintiff. The finder of facts made his findings and the Eighth Circuit could find no fault with them under the "clearly erroneous" stand. This is, therefore, an inappropriate case on which to grant a Writ.

II. The Circuit Court Did Not Specifically Decide That A Showing of Recklessness Was Insufficient To Establish Scienter Under Rule 10b-5.

In his Petition, plaintiff argues that the Circuit Court "decided an important question of federal law" and intimates that it specifically held that recklessness does not satisfy the scienter required by *Ernst & Ernst v. Hochfelder,* 425 U.S. 95 (1976). The Eighth Circuit did nothing of the sort. In fact, respondents-defendants agreed in their Eighth Circuit brief that—for purposes of the appeal—recklessness could be taken as the appropriate standard. There is no indication that the Eighth Circuit did not use that standard; even if applied it would make no difference, of course, because the trial court made no finding of reckless behavior; in fact the court implicitly found no reckless behavior.

By finding "laxity" without causation on only one issue the trial court implicitly found no recklessness. There is, in short, no basis whatever for concluding that the trial judge used a narrow definition of fraud or found reckless behavior by defendants yet refused to find them liable.

This is a most inappropriate case to use as a springboard for a broad statement on recklessness and the precise quantum of evidence necessary to satisfy the scienter standard. Petitioner-plaintiff apparently seeks a decision on that issue, despite the fact that its relationship to his case is academic. He has shown that a number of the circuits do in fact hold to recklessness as a suitable standard for scienter. Respondents have agreed, for purposes of the appeal, that recklessness may be taken as a standard and have so argued in their brief before the Eighth Circuit. Nearly all the courts agree that a standard of recklessness is appropriate; there is no seething conflict. Moreover, there is no showing that the Eighth Circuit disagrees, or disagreed in this case. There is in short, no reason for this Court to grant the petition of plaintiff.

CONCLUSION

For the reasons herein stated, the Respondent urges that the petition be denied.

Respectfully submitted,

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